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POSTAL REGULATORY COMMISSION
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Valassis NSA — Docket No. MC2012-14

Valassis NSA — Docket No. R2012-8

COMMENTS BY WILLIAM C. MILLER IN RESPONSE TO THE POSTAL REGULATORY COMMISSION'S NOTICE AND ORDER CONCERNING THE FILING OF CONTRACT AND SUPPORTING DATA AND REQUEST TO ADD VALASSIS DIRECT MAIL, INC. NEGOTIATED SERVICE AGREEMENT TO THE MARKET DOMINANT PRODUCT LIST

(May 23, 2012)

INTRODUCTION

On April 30, 2012, the Postal Service filed a notice requesting that the Postal Regulatory Commission (PRC) review and approve a proposed negotiated service agreement (NSA) between the Postal Service and Valassis Direct Mail, Inc. (Valassis).[1] The Postal Service states that the objective of the NSA is "to maintain the total contribution the Postal Service receives from Valassis Saturation Mail postage and provide an incentive to Valassis to find innovative ways to expand its use of Standard Mail." Notice at 1. The Postal Service requested that upon approval, the PRC add the NSA to the market dominant product list within the Mail Classification Schedule.

[1] Notice of the United States Postal Service of Filing of Contract and Supporting Data and Request to Add Valassis Direct Mail, Inc. Negotiated Service Agreement to the Market-Dominant Product List, April 30, 2012 (Notice).

In response, the Commission issued Order No. 1330 requesting interested parties to file comments on whether the proposed NSA is consistent with 39 U.S.C. 3622 and 3642, as well as 39 CFR parts 3010 and 3020. [2] Among other required provisions for NSAs, Section 3622(c)(10)(A)(i) of the Postal Accountability and Enhancement Act (PAEA) requires the Commission to consider as a criterion for approval whether or not agreements between the Postal Service and particular mailers have the effect of increasing the Postal Service's net contribution and financial position. Given the Postal Service's current financial crisis, the following comments address this particular aspect of the Postal Service's request.

BACKGROUND

In the proposed NSA, the Postal Service offers Valassis discounted rates for saturation mail advertising for large durable and semi-durable good retailers who can sustain a broad geographic presence. To be eligible for the program, these firms must operate retail outlets in 30 or more states. Notice at 4. The intent is to expand volume dramatically in a potentially large market which up to now has been largely untapped by Valassis. Current users (retailers) of existing Valassis mail programs (including senders of solo mail), however, are excluded from paying discounted rates in order to preserve the Postal Service's contribution from these programs. Valassis is also limited to offering this new program only in zip codes serviced by the current programs. Thus by protecting against mail diversion to the new program, the Postal Service claims that it expects to generate an additional \$13 Million to \$42 Million in contribution from new market expansion alone. A key factor in the Postal Service's estimate is the preservation of the existing contribution by assuming zero mail migration from the existing programs to the new discount eligible program. The Postal Service's estimates also assume no incremental fixed costs to administer the NSA.

[2] Notice and Order Concerning the Filing of Contract and Supporting Data and Request to add Valassis Direct Mail, Inc. Negotiated Service Agreement to the Market Dominant Product List, May 3, 2012.

Since the added contribution depends crucially on zero or minimal mail migration, the agreement includes several compliance related provisions intended to insulate the program from any contribution reducing volume diversion. However all details with respect to Valassis compliance with mail eligibility requirements have not been fully delineated. In particular, the Postal Service states "Procedures for auditing compliance with the terms and conditions described in this agreement will be established by the Postal Service after consulting with Valassis." [3]

However the agreement, as now structured, does contain the following major provisions. First, mail qualifying for discounts will be entered into the Postal One ™ system and designated as qualifying mail in dedicated program accounts. This will allow new and existing program Valassis mail volume and weight to be separately tracked and reported. Second, the new tracking system will be used to audit NSA mail volume and weight on a quarterly basis for eligibility requirements by retailer and mail piece (including required ranges for piece weight, number of inserts per mail piece, and physical dimensions). In a clarifying response, the Postal Service states that retailers with at least 50 percent of revenues derived from durable/semi-durable good sales would qualify for the discount (along with the geographic presence criterion). [4] Third, Valassis will pay a penalty equal to the published price for solo mail for any existing solo piece diverted to the new program.

Additionally the Postal Service, as part of its filing, proposes a data collection plan for a report to be submitted to the PRC within sixty days of the end of each contract year. [5] The information contained in the report will contain NSA volumes, gross revenues, discounts remitted to Valassis, net program revenues, and penalties paid by Valassis for the mailing of ineligible solo pieces. Presumably, this information would aid the Commission in assessing NSA compliance as part of annual compliance determination obligation.

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[3] Negotiated Service Agreement Between the United States Postal Service and Valassis Direct Mail, Inc., Attachment B of Notice, p. 5 (Agreement).

[4] Response to Question three of the United States Postal Service to Chairman's Information Request No. 2, May 18, 2012.

[5] Data Collection Plan, Attachment D of Notice.

ASSESSMENT

Allowed Volume Diversion

Data collected by Valassis and provided to the Postal Service on a quarterly basis will form a key component in the Postal Service's ability to effectively monitor compliance against contribution reducing volume diversion. It appears that the tracking system to be employed by the Postal Service will allow it to track new program mailings to qualifying retailers and to determine total mailings for existing programs and weight per mailing piece. However, it also appears that planned reports to be submitted to the Commission would only contain the NSA data. Without annual data on existing Valassis programs to be monitored by the Postal Service quarterly, it would be difficult for the Commission to assess NSA compliance with Section 3622(c)(10)(A)(i) of the PAEA.

The tracking system's capacity to trace average weight per piece for existing mail is a particularly important aspect of the monitoring process. Any weight reduction that does not affect existing mail volume appreciably would be particularly problematic because of reduced revenues with little accompanying cost reduction (since the same number of mail pieces would still have to be handled and delivered). However, the general exclusion of piggy-back arrangements in NSA mailings, allowing two or more inserts from different retailers in the same mail piece, should protect against this result, if mailer eligibility is well monitored. The other type of contribution loss would come from switching non-eligible piece mailings to price discounted mailings without affecting piece weight appreciably. Careful monitoring of mailer eligibility for new program mailings should also protect against this eventuality.

However despite these contractual arrangements, it appears that the current agreement might still allow for some volume diversion from the existing base to occur. In their clarifying response, the Postal Service admits that any current Valassis retailer with more than 50 percent of their revenues generated from sales of durable/semi-durable goods would apparently be allowed to enroll in the program, while meeting other eligibility criteria. The Postal Service appears to acknowledge the presence of such retailers in the Valassis customer profile when stating:

> Thus, the contracted flat rate offered to Valassis under the Standard Mail Saturation Mail pricing structure, combined with the conditions of the agreement, have been designed to foster Valassis' development of new multi-market saturation share mail programs for particular retailers that, as a whole, currently underutilize the mail for distribution of their advertising circulars in Valassis' existing markets**.** Notice at 3.

If such diversion is possible, it is not apparent that accompanying contribution effects are included in the incremental contribution estimates provided by the Postal Service. [6]

Postal Service NSA Administrative Expenses

The Postal Service does not include in its contribution estimates any fixed administrative expenses that would be generated to manage the new program, despite dramatic program expansions estimated in the second and third years of the contract under both low and high volume scenarios. These expenses would be fixed with respect to volume but not necessarily other cost drivers that are correlated with volume levels. Under the low volume scenario, first year NSA volume jumps from 11.3 Million to 40.8 Million pieces in year two (261 percent increase), and under the high scenario, first year volume of 56.5 Million increases to 175.5 Million in the following year (211 percent increase). The third year amounts are 85.8 Million for the low scenario (110 percent increase from year two) and 208 Million for the high scenario (18.5 percent increase from year two). [7]

This level of program expansion might very well affect the Postal Service's administrative workload and related expenses as well, especially if most of the volume increase is generated by the inclusion of new retailers in the last two years of the agreement. In fact, this would be the normal expectation if the volume expansion per

[6] It is not entirely clear whether estimates include values for all NSA program mailings less any contribution reduction from existing mailers allowed to transfer into the program, or just the former element only.

[7] Contained in Excel spreadsheet VDM_NSA_Financial Model Final accompanying Notice (Financial Model).

mailer takes place largely in the first year in response to the price discount. The documented out-year volume increases would then be due mostly to new retailers added to the program. The number of Valassis retailers might substantially drive Postal Service NSA administrative expenses related to compliance review and other matters.

Uniform Pricing at Contract End

The proposed NSA is largely silent on what happens to the two tier pricing system for Valassis mail at the end of the agreement in three years. However language in the agreement suggests the return to a uniform pricing system for all Valassis saturation mail at a yet undetermined rate level. In particular, the NSA states:

> In each such market where Valassis initiates a new program under this agreement Valassis must maintain its existing shared mail program in that market for the duration of the agreement. Agreement at 3.

Also in referring to the PostalOne ™ permit accounts, the NSA contains the following language:

> The dedicated permits are intended for the sole purpose of mailings identified in this agreement. No additional volume is permitted to be entered under these permits during the life of this agreement. Agreement at 5.

Both statements appear to infer that the distinction between the new and existing mail programs is dissolved with contract termination and that Valassis would be eligible to pay discounted rates for mail now delivered under its existing mail program, unless the discounted rates were negotiated to some new level. If this is a fair reading of the language, then the issue arises of whether the servicing of all Valassis mail by the Postal Service at lower than current undiscounted rates after contract end would yield a contribution that is at least equal to that now derived from the existing mail programs. If not, then any NSA incremental contribution gains could be quickly diluted by post contract incremental losses. In essence, if rates for existing markets were reduced to current discounted levels, then this would be tantamount to a post contract 100 percent mail migration to the lower rate structure under the NSA's interpretation. Presumably, the NSA prohibit any such migration now because of the negative effect on total Valassis contribution.

The post contract rate structure for Valassis is not an insignificant issue, given the Postal Service’s financial predicament. Market dominant NSAs have been used in the past by the Postal Service as a device to expand markets, generate incremental volume with a consequential result which is beneficial to the Postal Service and the mailer under contract. The current NSA is no exception. The Postal Service claims that direct mail advertising for durable and non-durable good retailers has been largely underutilized. Therefore discounting present pricing for Valassis in order to further develop that market will surely be beneficial to Valassis and potentially beneficial to the Postal Service. However, if rates for the existing market are reduced to create a uniform rate structure at the end of the agreement, then the existing volume base must expand sufficiently in response to the rate reduction in order for contribution from this market to increase. Otherwise, the post agreement contribution from Valassis mail in total could be lower than at present. [8]

To gain a greater perspective on possible results, a preliminary analysis was conducted using averaged Postal Service data for the flat saturation market. Details on the calculation and data used are presented in the Appendix. Ideally, Valassis volume data distributed by weight cell and destination entry point should be used but that data are unavailable. However the averaged data does shed some light on how critical parameters such as the demand elasticity for the existing Valassis market can affect the result. The demand elasticity captures the sensitivity of the volume response to a drop in Valassis base rates now paid, and therefore whether discounted rates for all mail can lead to contribution increasing results in total.

The calculation shows that the Postal Service would lose 2.93 cents in contribution for each piece of existing volume that is price discounted by an average of the individual percentages proposed in the NSA by weight cell. Thus for each 1000 pieces of existing volume that are price discounted, the Postal Service could lose $29.30 annually beyond

[8] The total contribution would be lower if the contribution loss attributable to the existing market is greater than the gain documented by the Postal Service for the new market at contract end.

the last contract year, according to this calculation. [9] The calculation is based on the Postal Service's latest demand elasticity of -.782 for Standard Enhanced Carrier Route (ECR) Mail. [10] The contribution loss would be reduced as demand elasticity increases in absolute value and would eventually turn positive at some value in the elastic range (where the value is greater than one in absolute value). [11] This entire issue should be studied in greater depth to ensure that the Postal Service continues to derive a contribution from Valassis mail, beyond the NSA three year period, that is no lower than the present contribution and preferably greater than this level.

CONCLUSION

Based on the incremental contribution estimated submitted by the Postal Service, It appears that the proposed NSA will be beneficial to the Postal Service and Valassis. Therefore the NSA should be approved by the Commission, if the Commission also concludes that provisions in the agreement also satisfy Section 3622(c)(10)(B). The compliance measures included in the agreement appear to be adequate to prevent a significant level of diversion of existing volume to the new program. However data collected as part of the program will need to be carefully monitored by both parties to ensure the desired result.

However at some point, the Commission should request that the Postal Service verify whether the incremental contribution estimates included in the filing account for any volume generated by existing Valassis customers who would be eligible for discounted rates. Principally, these would include retailers who now derive more than 50 percent of their revenues from durable/semi-durable good sales and have a retail presence in 30 or

[9] This figure is based on unit price and cost data escalated to the third year of the agreement based on index data used by the Postal Service to develop the NSA incremental contribution estimate. See Financial Model.

[10] Demand Analyses and Volume Forecast Materials for Market Dominant Products, January 20, 2012.

[11] According to the Postal Service, Valassis mail volume exceeded three billion pieces in each of the last two fiscal year. The actual contribution effect would be based on some portion or all of this volume that would be subject to uniform pricing at contract end. Of course, the contribution change from NSA volume would also need to be part of any analysis if the current discount structure were changed to arrive at the uniform pricing structure.

more states. Second, the Commission should ask the Postal Service to modify their contribution estimates by any incremental administrative expenses that may be created because of the new program. There is a significant program expansion expected in the second and third contract years which may precipitate such costs. Third, the Commission should request that the Postal Service modify its data collection plan so that annual Valassis data on NSA and non-NSA mail volumes and piece weights are reported to the Commission at a minimum. These data would assist the Commission in fulfilling its annual compliance related responsibilities with respect to the NSA.

Last, it is important to view Section 3622(c)(10)(A)(i) of the PAEA from a long run context. That is from the Postal Service's perspective, this NSA should be viewed as a mechanism to increase contribution permanently for the benefit of both parties. Surely, this was the intent of the Congress as imbedded in the language. Once new contribution increasing markets are developed through price discounting, the issue of how to secure realized gains on a permanent basis then becomes important. Post contract pricing arrangements play a crucial role in this regard.   As Valassis data become available for compliance-related purposes, there is an opportunity to study this issue further so that both Valassis and the Postal Service realize permanent benefits.

APPENDIX

This appendix explains the calculations used to estimate the per piece change in contribution to the Postal Service from existing Valassis mail volume when reducing base Valassis rates by the average percentage proposed in the NSA. The actual calculations are then presented at the end. The following notation is used in the description.

Notation:

V_O^E = volume for existing markets at existing rate,
V_1^E = volume for existing markets at discounted rate,
P_O = existing rate,
P_1 = discounted rate,
$k = (P_0 - P_1)/P_0$ = discount factor,
π_0^E = contribution from the existing market at the existing rate,
π_1^E = contribution from the existing market at the discounted rate,
$\epsilon^E = (dV^E/dP)P_0/V_O^E$ = demand elasticity for existing markets measured at the existing price and volume (P_O, V_O^E),
u = attributable unit cost.

The initial step is to write a first order estimate of the volume response from lowering the rate to the discounted level as:

$$V_1^E - V_O^E \approx (dV^E/dP)(P_1 - P_O).$$

Note that if demand is linear, the estimate is exact because the slope of the demand function (dV^E/dP) is constant at all rates. By appropriate substitution, the volume response can also be written in terms of the demand elasticity:

$$V_1^E - V_O^E \approx -kV_O^E\epsilon^E.$$

Since ϵ^E is negative by $(dV^E/dP) < 0$, a positive volume response is indicated for any non-zero discount factor.

The volume estimate at the discounted rate can then be written as:

$$V_1^E \approx V_O^E(1{-}k\epsilon^E),$$

Since contribution at the discounted rate is $\pi_1^E = V_1^E(P_1 - u) = V_1^E(P_0 - kP_0 - u)$, an estimate for π_1^E can be formed by substituting $V_0^E(1{-}k\epsilon^E)$ for V_1^E. This gives:

$$\pi_1^E \approx V_O^E(1{-}k\epsilon^E)(P_0 - kP_0 - u).$$

As before note that if demand is linear, then the contribution estimate is exact.

After some algebra, the last expression reduces to:

$$\pi_1^E \approx V_O^E(P_0 - u) + V_O^E[-kP_o(1+\epsilon^E) + ku\epsilon^E + k^2 P_0 \epsilon^E].$$

Finally noting that $V_O^E(P_0 - u)$is the contribution at the existing rate, an estimate of the contribution change from a non-zero k can be shown as:

$$\pi_1^E - \pi_0^E \approx V_O^E[-kP_o(1+\epsilon^E) + ku\epsilon^E + k^2 P_0 \epsilon^E].$$

In the above expression, the sum $V_O^E[-kP_o(1+\epsilon^E) + k^2 P_0 \epsilon^E]$ denotes the change in revenue and the term $V_O^E ku\epsilon^E$ denotes the change in cost. Note that a positive revenue effect depends on $-kP_o(1+\epsilon^E)$ > 0 from elastic demand ($\epsilon^E < -1$). Otherwise, the revenue effect must be negative (because $k^2 P_0 \epsilon^E$ is negative) and the lower rate must reduce contribution as well.

The bracketed term in the last expression serves as a multiplier which can be applied to any portion of the Valassis base (Non-NSA) volume to derive the effect on the existing contribution from the reducing the average rate on that portion. The multiplier is derived according to the following values: P_0 =.166, u = .080, k = .2284, ϵ^E= -.782. The undiscounted rate P_0 =.166 is the average for piece and pound saturation flats from the FY 2011 billing determinants used by the Postal Service to estimate the undiscounted unit contribution per piece for NSA pieces. Financial Model. The unit attributable cost u = .080 is the drop-ship adjusted value for SCF entered pieces used by the Postal Service in their analysis. *Id.* Although most Valassis mail is handled and delivered at a lower unit cost because of DDU entry, the higher SCF figure is used to provide a lower bound estimate for the multiplier. Values for both P_0 and u are escalated to third year contract values, as indicated by the Postal Service calculations. The discount factor k = .2284 is a simple average of the discount factors proposed in the NSA for each of the weight cells for qualifying mail. *Id.* The demand elasticity ϵ^E= -.782 is the value supplied by the Postal Service for its latest Standard ECR demand model.

These values can be plugged into the formula to calculate a contribution change for each piece of existing mail that would receive a 22.84 percent discount:

$$-.0293 = [-.2284*.166*(1-.782)\ ] + [.2284*.080*(-.782)\ ] + [(.2284)^2*.166*(-.782)\ ].$$

The calculation shows that the Postal Service could lose almost three cents in contribution annually, starting at contract end, for each piece of existing mail that pays a rate that is 22.84 percent lower than its estimated base rate. If demand were entirely unresponsive to price changes ($\epsilon^E = 0$), then the per piece contribution would change by $-.0379\ =\ -.2284 \times .166$, the same as the actual change in the unit contribution. The difference in the two values ($-.0293$ and $-.0379$) is explained by the volume expansion and consequential reduction in the contribution loss caused by the lower rate for any value of V_O^E. Thus the positive volume response reduces the contribution loss by about 23 percent for any value of V_O^E.